

## Chapter 2

### Multiple Choice

1. Which early accounting theorist was among the first to express the view that all changes in the value of assets and liabilities should be reflected in the financial statements?
  - a. A. C. Littleton
  - b. John Canning
  - c. William Paton
  - d. DR Scott

Answer c

2. Which of the following economists most influenced the views of DR Scott?
  - i. Thorstein Veblen
  - ii. John Hicks
  - iii. Karl Marx
  - iv. John Smith

Answer a

3. Which of the following is not one of DR Scott's hierarchy of accounting postulates and principles?
  - a. Orientation postulate.
  - b. The principles of truth and fairness.
  - c. The materiality principle
  - d. The principles of adaptability and consistency.

Answer c

4. Which of the following organizations published the monograph titled *A Tentative Statement of Accounting Principles Affecting Annual Corporate Reports*?
  - a. SEC
  - b. AAA
  - c. AIA
  - d. NAA

Answer b

5. Which of the following organizations published the monograph titled *A Statement of Accounting Principles*?
  - a. SEC
  - b. AAA
  - c. AIA

- d. NAA

Answer c

- 6. Who was the author of Accounting Research Study No. 1, *The Basic Postulates of Accounting*?
  - a. Robert Sprouse
  - b. Maurice Moonitz
  - c. Alvin Jennings\
  - d. Thomas Hatfield

Answer b

- 7. Which of the following is not an approach to accounting theory as categorized by *Statement on Accounting Theory and Theory Acceptance*?
  - a. Classical,
  - b. Neoclassical
  - c. Decision usefulness
  - d. Information economics.

Answer b

- 8. What is the objective of financial reporting?
  - a. Provide information that is useful to management in making decisions.
  - b. Provide information that clearly portrays nonfinancial transactions.
  - c. Provide information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors.
  - d. Provide information that excludes claims to the resources.

Answer c

- 9. Under Statement of Financial Accounting Concepts No. 8, confirmatory value is an ingredient of the primary quality of

	<u>Relevance</u>	<u>Faithful representation</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

Answer d

- 10. Which of the following is considered a constraint by Statement of Financial Accounting Concepts No. 8?
  - a. Cost
  - b. Conservatism

- c. Timeliness
- d. Verifiability

Answer a

11. Under Statement of Financial Accounting Concepts No. 8, which of the following is an ingredient of the primary quality of relevance?
- a. Neutrality
  - b. Completeness
  - c. Understandability
  - d. Verifiability

Answer b

12. Under Statement of Financial Accounting Concepts No. 8, which of the following is an ingredient of the primary quality of faithful representation?
- a. Understandability
  - b. Verifiability
  - c. Predictive value
  - d. Materiality

Answer b

13. Under Statement of Financial Accounting Concepts No. 8, the ability through consensus of measures to ensure that information represents what it purports to represent is an example of the concept of
- a. Relevance
  - b. Verifiability
  - c. Faithful representation
  - d. Feedback value

Answer c

14. Under Statement of Financial Accounting Concepts No. 8, which of the following relates to both relevance and reliability?
- a. Timeliness
  - b. Materiality
  - c. Predictive value
  - d. Neutrality

Answer a

15. Under Statement of Financial Accounting Concepts No. 8, which of the following is **not** a qualitative characteristic associated with faithful representation?

- a. Completeness
- b. Free from error
- c. Neutrality
- d. Predictive value

Answer d

16. What is meant by comparability when discussing financial accounting information?
- a. Information has predictive or confirmatory value.
  - b. Information is reasonably free from error.
  - c. Information that is measured and reported in a similar fashion across companies.
  - d. Information is timely.

Answer c

17. What is meant by consistency when discussing financial accounting information?
- a. Information that is measured and reported in a similar fashion across points in time.
  - b. Information is timely.
  - c. Information is measured similarly across the industry.
  - d. Information is verifiable

Answer a

18. An item is considered material if
- a. It doesn't cost a lot of money.
  - b. It is of a tangible good.
  - c. It is likely to influence the decision of an investor or creditor.
  - d. The cost of reporting the item is greater than its benefits

Answer c

19. If the FASB's proposed definition of materiality as a legal concept is adopted the most likely outcome is
- a. It will have little impact on the number of items classified as material
  - b. It will lower the threshold for recognizing event and transactions as material
  - c. It will raise the threshold for recognizing event and transactions as material
  - d. Its impact cannot be determined

Answer c

20. What is the purpose of Emerging Issues Task Force?
- a. Provide interpretation of existing standards.
  - b. Provide a consensus on how to account for new and unusual financial transactions.
  - c. Provide interpretive guidance.

- d. Provide timely guidance on select issues

Answer b

21. Which of the following is not a topic being currently studied by the FASB in its disclosure framework project?
- a. Fair value measurement
  - b. Defined benefit pension plans
  - c. Leases
  - d. Income taxes

Answer c

### **Essay**

1. Discuss the contributions of Paton and Canning to the development of accounting theory.

The first attempts to develop accounting theory in the United States have been attributed to William A. Paton and John B. Canning. Paton's work, based on his doctoral dissertation, was among the first to express the view that all changes in the value of assets and liabilities should be reflected in the financial statements, and that such changes should be measured on a current value basis.

He also maintained that all returns to investors (both dividends and interest) were distributions of income, and consequently he espoused the entity concept rather than the prevailing proprietary concept. An additional contribution of this work was an outline of what Paton believed to be the basic assumptions or postulates underlying the accounting process. Paton's basic assumptions and postulates can be viewed as the first step in the development of the conceptual framework of accounting. Canning's work suggested a framework for asset valuations and measurement based on future expectations as well as a model to match revenues and expenses. At this time, the balance sheet was viewed as the principal financial statement, and the concept of capital maintenance was just emerging.

2. Discuss the contribution DR Scott to the development of accounting theory.

During this early period, significant contributions to the development of a conceptual framework of accounting were also made by DR Scott. Scott was viewed as an outsider; however, his writings have proven to be quite insightful. Scott was originally trained as an economist and was heavily influenced by the views of his colleague, the economist and philosopher Thorstein Veblen. He adopted Veblen's view that many academics were overly occupied with refining the details of existing theories when there was a need for the reexamination of fundamental assumptions. Both Scott and Veblen viewed the Industrial Revolution as changing the fundamental fabric of our society. Scott believed the Industrial Revolution caused managers to look for new methods of maintaining organizational control. As a result, scientific methods such as accounting and statistics became organizational control tools.

Scott contributed to the development of accounting theory by recognizing the need for a normative theory of accounting. This view, described in several publications from 1931 to 1941, evolved into a description of his conceptual framework in “The Basis for Accounting Principles.

In his first important work, *The Cultural Significance of Accounts*, Scott argued that accounting theory was not a progression toward a static ideal but rather a process of continually adapting to an evolving environment. The notion of adaptation later became one of Scott’s principles in his conceptual framework. He approached accounting from a sociological perspective. The basic premise presented in *Cultural Significance* was that the economic basis of any culture is shaped by the institutional superstructure of the society in question. This view later evolved into his orientation postulate.

Scott’s next important work was a response to the American Accounting Association’s “A Tentative Statement of Principles Underlying Corporate Financial Statements” (discussed later in the chapter). Scott criticized the AAA monograph as having a too narrow view of accounting in that it addressed only accounting’s transaction function. Rather, he saw accounting as encompassing other important functions, such as managerial control and the protection of the interests of equity holders. He also viewed accounting as having both an internal control function and an external function to act for the protection of various economic interests such as stockholders, bond holders, and the government.

Although Scott’s first two works contain what were to become elements of his conceptual framework, the first step in its articulation is contained in “Responsibilities of Accountants in a Changing Environment.” In this work he again alluded to the influence of the Industrial Revolution on a changing economy and saw it as requiring improved financial reporting to meet the needs of all investors. Scott supported Paton’s earlier acceptance of the entity theory and went on to emphasize that accounting must meet the needs of external users. This view is an example of why Scott was considered an outsider, because the prevailing view was that accounting should be designed to benefit the firm’s management or proprietor (the proprietary theory).

3. Discuss DR Scott’s hierarchy of postulates and principles.

In 1941 Scott unveiled his conceptual framework in “The Basis for Accounting Principles.” He maintained that it could serve as a vehicle for the development of internally consistent accounting principles. Scott’s framework includes the following hierarchy of postulates and principles to be used in the development of accounting rules and techniques.

- a. **Orientation Postulate.** —Accounting is based on a broad consideration of the current social, political, and economic environment.
- b. **The Pervasive Principle of Justice.** —The second level in Scott’s conceptual framework was justice, which was seen as developing accounting rules that offer equitable treatment to all users of financial statements.

- c. **The Principles of Truth and Fairness.** —Scott's third level contained the principles of truth and fairness. Truth was seen as an accurate portrayal of the information presented. Fairness was viewed as containing the attributes of objectivity, freedom from bias, and impartiality.
  - d. **The Principles of Adaptability and Consistency.** —The fourth level of the hierarchy contained two subordinate principles, adaptability and consistency. Adaptability was viewed as necessary because society and economic conditions change; consequently, accounting must also change. However, Scott indicated a need to balance adaptability with consistency by stating that accounting rules should not be changed to serve the temporary purposes of management.
4. Discuss the contributions of the works by Sanders Hatfield and More, and Paton and Littleton to accounting theory.

In 1938, the American Institute of Accountants (AIA) also published a monograph, *A Statement of Accounting Principles*, written by Thomas H. Sanders, Henry Rand Hatfield, and Underhill Moore, that ostensibly described accounting theory. The goal of this publication was to provide guidance to the SEC on the best accounting practices. However, the study did not accomplish its objective because it was viewed as a defense of accepted practices rather than an attempt to develop a theory of accounting.

In 1940, the AAA published a benchmark study by Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards*. While this study continued to embrace the use of historical cost, its major contribution was the further articulation of the entity theory. It also described the matching concept, whereby management's accomplishments (revenue) and efforts (expenses) could be evaluated by investors. This monograph was later cited as developing a theory that has been used in many subsequent authoritative pronouncements.

5. Discuss accounting Research Study No. 1.

Accounting Research Study No. 1, *The Basic Postulates of Accounting*, was published in 1961. It consisted of a hierarchy of postulates encompassing the environment, accounting, and the imperatives as follows:

#### Group A Economic and Political Environmental Postulates

This group is based on the economic and political environment in which accounting exists. They represent descriptions of those aspects of the environment that Sprouse and Moonitz presumed to be relevant for accounting.

#### **A-1. Quantification**

Quantitative data are helpful in making rational economic decisions. Stated differently, quantitative data aid the decision maker in making choices among alternatives so that the actions are correctly related to consequences.

**A-2. Exchange**

Most of the goods and services that are produced are distributed through exchange and are not directly consumed by the producers.

**A-3. Entities**

Economic activity is carried on through specific units of entities. Any report on the activity must identify clearly the particular unit or entity involved.

**A-4. Time period. (Including specification of the time period.)**

Economic activity transpires during specifiable time periods. Any report on that activity must specify the period involved.

**A-5. Unit of measure. (Including identification of the measuring unit.)**

Money is the common denominator in terms of which goods and services, including labor, natural resources, and capital, are measured. Any report must clearly indicate which monetary unit is being used.

**Group B Accounting Postulates**

The second group of postulates focuses on the field of accounting. They are designed to act as a foundation and assist in constructing accounting principles.

**B-1. Financial statements. (Related to A-1.)**

The results of the accounting process are expressed in a set of fundamentally related financial statements that articulate with each other and rest on the same underlying data.

**B-2. Market prices. (Related to A-2.)**

Accounting data are based on prices generated by past, present, or future exchanges that have actually taken place or are expected to.

**B-3. Entities. (Related to A-3.)**

The results of the accounting process are expressed in terms of specific units or entities.

**B-4. Tentativeness. (Related to A-4.)**

The results of operations for relatively short periods are tentative whenever allocations between past, present, and future periods are required.

**Group C Imperative Postulates**

The third group differs fundamentally from the first two groups. They are not primarily descriptive statements but instead represent a set of normative statements of what should be, rather than statements of what is.

**C-1 Continuity. (Including the correlative concept of limited life.)**



In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.

### **C-2. Objectivity**

Changes in assets and liabilities and the related effect (if any) on revenues, expenses, retained earnings, and the like should not be given formal recognition in the accounts earlier than the point of time at which they can be measured objectively.

### **C-3. Consistency**

The procedures used in accounting for a given entity should be appropriate for the measurement of its position and its activities and should be followed consistently from period to period.

### **C-4. Stable unit**

Accounting reports should be based on a stable measuring unit.

### **C-5. Disclosure**

Accounting reports should disclose that which is necessary to make them not misleading.

7. How did ASOBAT define accounting and what two new ideas arose from this monograph?

*A Statement of Basic Accounting Theory (ASOBAT)* in 1966 defined accounting as “the process of identifying, measuring and communicating economic information to permit informed judgments and decision by users of the information.”

Two new ideas arose out of *ASOBAT*'s definition of accounting. The members of the committee were mainly academics, so they looked upon accounting as an information system. Therefore, they saw communication as an integral part of the accounting process. Additionally, the inclusion of the term *economic income* broadened the scope of the type of information to be provided to assist in the allocation of scarce resources. The committee also embraced the entity concept by indicating that the purpose of accounting was to allow users to make decisions. In essence they were defining accounting as a behavioral science whose main function was to assist in decision making. As a consequence, the committee adopted a decision-usefulness approach and identified four standards to be used in evaluating accounting information: relevance, verifiability, freedom from bias, and quantifiability. *ASOBAT* maintained that if these four standards could not be attained, the information was not relevant and should not be communicated.

*ASOBAT* noted the inherent conflicts between relevance and verifiability in making one final recommendation. The monograph called for the reporting of both historical cost and current cost measures in financial statements. The current cost measures to be used included both replacement cost and price level adjustments.

6. Discuss the objectives of accounting as outlined by the Trueblood Committee.  
The Trueblood Committee report specified the following four information needs of users:

1. Making decisions concerning the use of limited resources
2. Effectively directing and controlling organizations
3. Maintaining and reporting on the custodianship of resources
4. Facilitating social functions and controls

Like its predecessors, the Trueblood Committee had difficulty agreeing on the answers to the questions proposed by the AICPA. As a result, it indicated that its final report be regarded as a first step in the process. The report listed the following objectives for financial reporting:

1. The basic objective of financial statements is to provide information useful for making economic decisions.
2. An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.
3. An objective of financial statements is to provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows in terms of amount, timing, and related uncertainty.
4. An objective of financial statements is to provide users with information for predicting, comparing, and evaluating enterprise earning power.
5. An objective of financial statements is to supply information useful in judging management's ability to use enterprise resources effectively in achieving its primary enterprise goal.
6. An objective of financial statements is to provide factual and interpretative information about transactions and other events that is useful for predicting, comparing, and evaluating enterprise earning power. Basic underlying assumptions with respect to matters subject to interpretation, evaluation, prediction, or estimation should be disclosed.
7. An objective is to provide a statement of financial position useful for predicting, comparing, and evaluating enterprise earning power.
8. An objective is to provide a statement of periodic earnings useful for predicting, comparing, and evaluating enterprise earning power.
9. Another objective is to provide a statement of financial activities useful for predicting, comparing, and evaluating enterprise earning power. This statement should report mainly on factual aspects of enterprise transactions having or expecting to have significant cash consequences. This statement should report data that require minimal judgment and interpretation by the preparer.
10. An objective of financial statements is to provide information useful for the predicting process. Financial forecasts should be provided when they will enhance the reliability of the users' predictions.
11. An objective of financial statements for governmental and not-for-profit organizations is to provide information useful for evaluating the effectiveness of the management of resources in achieving the organization's goals. Performance measures should be quantified in terms of identified goals.
12. An objective of financial statements is to report on the enterprise's activities affecting society that can be determined and described or measured and that are important to the role of the enterprise in its social environment. This objective was an attempt to draw attention to those

enterprise activities that require sacrifices from members of society who do not benefit from those activities.

7. What were the approaches to accounting theory identified by SATTA?

*SATTA* first embarked on a review of accounting theories and found that a number of theories explained narrow areas of accounting. The committee noted that while there was general agreement that the purpose of financial accounting is to provide economic data about accounting entities, divergent theories had emerged because of the way different theorists specified users of accounting data and the environment. For example, *users* might be defined either as the owners of the accounting entity or more broadly to include creditors, employees, regulatory agencies, and the general public. Similarly, the environment might be specified as a single source of information or as one of several sources of financial information. The various approaches to accounting theory were condensed into (1) classical, (2) decision usefulness, and (3) information economics.

8. According to Kuhn, how does scientific progress occur?

*SATTA* noted that although the evolutionary view of accounting had considerable appeal, the evidence suggests that the existing accounting literature was inconsistent with that view. It suggested that the process of theorizing in accounting was more revolutionary than evolutionary and turned to a perspective developed by Kuhn. He suggests scientific progress proceeds in the following order:

1. Acceptance of a paradigm.
2. Working with that paradigm by doing normal science.
3. Becoming dissatisfied with that paradigm.
4. Search for a new paradigm.
5. Accepting a new paradigm.

9. What is the purpose of the conceptual framework?

The CFP first attempted to develop principles or broad qualitative standards to permit the making of systematic rational choices among alternative methods of financial reporting. Subsequently, the project focused on how these overall objectives could be achieved. As a result, the CFP is a body of interrelated objectives and fundamentals. The objectives identify the goals and purposes of financial accounting, whereas the fundamentals are the underlying concepts that help achieve those objectives. These concepts are designed to provide guidance in:

1. Selecting the transactions, events, and circumstances to be accounted for
2. Determining how the selected transactions, events, and transactions should be measured
3. Determining how to summarize and report the results of events, transactions, and circumstances.

The FASB intends the CFP to be viewed not as a package of solutions to problems but rather as a common basis for identifying and discussing issues, for asking relevant questions, and for suggesting avenues for research.

10. Define the following terms:

a. Comprehensive income

Comprehensive income is the change in equity (net assets) of an entity during a period from transactions and events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

b. Relevance

Relevant accounting information can make a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations. Relevant information has predictive value, feedback value, and timeliness.

c. Faithful representation

Faithful representation has three characteristics: *completeness*, *neutrality*, and *free from error*. Although perfection is difficult or even impossible to achieve, the objective is to maximize those qualities to the extent possible. A complete depiction should include all information necessary for a user to understand the phenomenon being depicted. For some items, a complete depiction also might entail explanations of significant facts about the quality and nature of the items, factors, and circumstances that might affect their quality and nature and the process used to determine the numerical depiction. A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, deemphasized, or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutral information does not mean information with no purpose or no influence on behavior. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. Information that is free from error will result in a more faithful representation of financial results.

11. According to *SFAC No. 5*, what should a full set of financial statements for a period show?

According to *SFAC No. 5*, a full set of financial statements for a period should show:

1. Financial position at the end of the period.
2. Earnings for the period.

3. Comprehensive income for the period.
4. Cash flows during the period.
5. Investments by and distributions to owners during the period.

12. What is the purpose of SFAC No. 7: "Using Cash Flow Information and Present Value in Accounting Measurements?"

The FASB indicated that the purpose of present-value measurements is to capture the economic difference between sets of future cash flows. For example, each of the following assets with a future cash flow of \$25,000 has an economic difference:

- a. An asset with a certain, fixed contractual cash flow due in one day of \$25,000.
- b. An asset with a certain, fixed contractual cash flow due in ten years of \$25,000.
- c. An asset with a certain, fixed contractual cash flow due in one day of \$25,000. The actual amount to be received may be less but not more than \$25,000.
- d. An asset with a certain, fixed contractual cash flow due in ten years of \$25,000. The actual amount to be received may be less but not more than \$25,000.
- e. An asset with expected cash flow of \$25,000 in ten years with a range of \$20,000 to \$30,000.

These assets are distinguished from one another by the timing and uncertainty of their future cash flows. Measurements based on undiscounted cash flows would have the result of recording each at the same amount. Since they are economically different, their expected present values are different. A present value measurement that fully captures the economic differences between the five assets should include the following elements:

- a. An estimate of future cash flows
- b. Expectations about variations in the timing of those cash flows
- c. The time value of money represented by the risk-free rate of interest
- d. The price for bearing the uncertainty
- e. Other, sometimes unidentifiable, factors including illiquidity and market imperfections

13. What two approaches to present value were discussed in SFAS No. 7?

The two approaches to present value were discussed in *SFAC No. 7*:

- **Traditional.** A single cash flow and a single interest rate as in a 12 percent bond due in ten years. Cases a and b above are examples of the use of the traditional approach.
- **Expected cash flow.** A range of possible cash flows with a range of likelihoods. Cases c, d, and e above are examples of the expected cash flow approach.

14. Discuss the qualitative characteristics of accounting information as outlined in SFAC No. 8

The qualitative characteristics are described in Chapter 3 of *SFAC No. 8* and distinguish between better (more useful) information and inferior (less useful) information.

These qualitative characteristics are either fundamental or enhancing characteristics, depending on how they affect the decision usefulness of information.

The two fundamental qualities that make accounting information useful for decision making are *relevance* and *faithful representation*.

Relevant financial information is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in decisions if it has predictive value and confirmatory value and is material. Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations. Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report. Consequently, the FASB was not able to specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena but also must faithfully represent the phenomena that it purports to represent. A perfectly faithful representation has three characteristics: *completeness*, *neutrality*, and *free from error*. Although perfection is difficult or even impossible to achieve, the objective is to maximize those qualities to the extent possible.

A complete depiction should include all information necessary for a user to understand the phenomenon being depicted. For some items, a complete depiction also might entail explanations of significant facts about the quality and nature of the items, factors, and circumstances that might affect their quality and nature and the process used to determine the numerical depiction. A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, deemphasized, or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutral information does not mean information with no purpose or no influence on behavior. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. Information that is free from error will result in a more faithful representation of financial results.

*Comparability*, *verifiability*, *timeliness*, and *understandability* are the qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items.

Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities.

Comparability is the goal; consistency helps to achieve that goal.

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

Quantified information need not be a single point estimate to be verifiable.

A range of possible amounts and the related probabilities also can be verified.

Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information can continue to be timely long after the end of a reporting period because, for example, some users might need to identify and assess trends. Understandability involves classifying, characterizing, and presenting information clearly and concisely.

15. Discuss the issue of principles based vs. rule based accounting standards.

To illustrate the difference between rules-based and principles-based standards, the standard-setting process can be viewed as a continuum ranging from highly rigid standards on one end to general definitions of economics-based concepts on the other end. For example, consider accounting for the intangible asset of goodwill. An example of the extremely rigid end of the continuum is the previously acceptable practice:

Goodwill is to be amortized over a period not to exceed 40 years.

This requirement leaves no room for judgment or disagreement about the amount of amortization expense to be recognized. Comparability and consistency across firms and through time is virtually assured under such a rule. However, the requirement lacks relevance because it does not reflect the underlying economics of the reporting entity, which differ across firms and through time.

At the opposite end of the continuum is the FASB ASC's 350-20-35-1 rule:

Goodwill shall not be amortized. Instead, goodwill shall be tested for impairment at a level of reporting referred to as a *reporting unit*.

This requirement necessitates the application of judgment and expertise by both managers and auditors. The goal is to record the economic deterioration of the asset, goodwill.

16. Discuss how the FASB and the IASB acted to improve comparability under the Norwalk Agreement.

In the Norwalk Agreement, the FASB and IASB committed to (1) undertake a short-term project aimed at removing a variety of individual differences between U.S. GAAP and International Financial Reporting Standards (IFRSs, discussed in Chapter 3); (2) remove other

differences between IFRSs and U.S. GAAP that remained at January 1, 2005, through coordination of their future work programs; that is, through the mutual undertaking of discrete, substantial projects that both Boards would address concurrently; (3) continue progress on the joint projects that they are currently undertaking; and (4) encourage their respective interpretative bodies to coordinate their activities.